Overview

The U.S. economy continues to exhibit robust growth, with a strong labor market and moderate inflation (see Chapter 1). These accomplishments are supported by rapid productivity growth that makes our economy one of the most dynamic and resilient in the world. Productivity growth is a common thread that ties nearly all positive economic news together and plays a central role in our international competitiveness.

Much of this *Report* explores the role of productivity and productivity-related issues in the continuing expansion of the U.S. economy. Policymakers face a challenge: productivity growth is important for economic growth and many of the underlying issues that they are trying to solve, but there is no single cause of productivity and no single policy to spur its growth (see Chapter 2). Tax policy can be structured to encourage productivity growth (see Chapter 3). Entitlement programs, on the other hand, may indirectly weigh on productivity growth if not reformed (see Chapter 4). Open commerce and financial markets allow productivity to flourish (see Chapters 7-9). Economists discuss productivity growth using macroeconomic data, but its result is most importantly seen in increases in individual Americans' standards of living.

Chapter 1: The Year in Review and the Years Ahead

The economic expansion continued for the fifth consecutive year in 2006. This economic growth comes despite numerous headwinds, and results from inherent U.S. economic strengths and pro-growth policies. Chapter 1 reviews the past year and discusses the Administration's forecast for the years ahead. The key points are:

- Real GDP posted above-average 3.4 percent growth in 2006. The composition of growth changed, with more coming from exports and business structures investment, while residential investment flipped from contributing to GDP growth in 2005 to subtracting from it in 2006. Consumer spending remained strong.
- Labor markets continued to strengthen, with the unemployment rate dropping to 4.6 percent and payroll job growth averaging 187,000 per month. Real average hourly earnings accelerated to a 1.7 percent increase during the 12 months of 2006.
- Energy prices rose sharply in the first half of the year, but then declined just as sharply in the second half.

Chapter 2: Productivity Growth

Productivity growth rarely makes the headlines, but is important to the Nation because higher productivity growth improves the outlook for economic issues such as standards of living, inflation, international competitiveness, and long-run demographic challenges. Chapter 2 reviews the sources of the recent strength in productivity growth, highlighting the role that flexible markets and entrepreneurship play in explaining cross-country differences. It also explains the benefits of productivity growth and discusses how policymakers can further promote it. The key points are:

- Recent productivity growth has been primarily driven by efficiency growth (growth in how well labor and capital inputs are used) and by capital deepening (growth in the amount of capital that workers have available for use).
- Openness to international trade and investment, and improvements in the education and training of the U.S. workforce, will continue to be important to long-run productivity growth.
- Policies that encourage capital accumulation, research and development, and increases in the quality of our education system can boost productivity growth.

Chapter 3: Pro-Growth Tax Policy

Chapter 3 discusses the advantages of adopting a more pro-growth tax system. It reviews recent changes that have reduced tax distortions on capital investment decisions, and evaluates options to reduce such distortions further. The key points are:

- The goal of pro-growth tax policy is to reduce tax distortions that hamper economic growth. Most economists agree that lower taxes on capital income stimulate greater investment, resulting in greater economic growth, greater international competitiveness, and higher standards of living.
- The tax code contains provisions that discourage investment and create distortions that affect the level, distribution, and financing of capital investment.
- Estimates from research suggest that removing these tax distortions to investment decisions could increase real gross domestic product (GDP) by as much as 8 percent in the long run.
- Since 2001, temporary changes in the tax code have reduced the tax on investment. These pro-growth policies have stimulated short-run investment and economic growth. However, the temporary nature of the provisions eliminates desirable long-run economic stimulus.

Chapter 4: The Fiscal Challenges Facing Medicare

Social Security, Medicare, and Medicaid are three entitlement programs in the United States that provide people with important economic security against financial risk. However, the projected long-term growth in entitlement spending is unsustainable because of the pressure it puts on future Federal budgets. It is crucial that reforms to these programs preserve the protection against financial risk that these programs provide without having negative effects on economic growth. Chapter 4 focuses on Medicare by examining the main reasons for its projected financial pressures and by discussing ways to improve the efficiency of the program and thus slow the growth of Medicare spending. The key points are:

- Medicare spending is growing quickly, primarily because of the demographic shift to an older society and the increases in per-beneficiary medical spending driven largely by new technologies.
- Rewarding providers for supplying higher-quality care and improving incentives for patients to choose higher-value care can both increase the efficiency and slow the growth of Medicare spending.

Chapter 5: Catastrophe Risk Insurance

Insuring economic losses arising from large-scale natural and manmade catastrophes such as earthquakes, hurricanes, and terrorist attacks poses challenges for the insurance industry and for Federal and State governments. Chapter 5 examines the economics of catastrophe risk insurance. The key points are:

- In insurance markets, as in other markets, prices affect how people weigh costs and benefits. Artificially low insurance prices can discourage people from adequately protecting against future losses. For example, subsidized property insurance prices may stimulate excessive building in high-risk areas, potentially driving up future government disaster relief spending.
- Government intervention in insurance markets can have unintended consequences, such as limiting the availability of insurance offered by private firms.
- Insurers manage catastrophe losses by being selective about which risks to insure, designing insurance contracts to provide incentives for risk-reducing behavior, and charging prices that are high enough to enable them to diversify risk over time or transfer risk to third parties. By managing and pricing risk more effectively, government insurance programs can reduce the burden they impose on taxpayers and minimize negative effects on private insurance markets.

Chapter 6: The Transportation Sector: Energy and Infrastructure Use

The transportation sector accounts for the majority of the petroleum consumed in the United States and—whether plane, train, ship, or automobile—almost all transportation is powered by petroleum. Understanding the petroleum market, and the ways in which consumers and firms respond to changes in world oil prices, is key to understanding the transportation sector. In addition to petroleum, the transportation sector also relies heavily on infrastructure. The key points of Chapter 6 are:

- Recent increases in the price of oil and the external costs of oil have led to renewed interest by markets and governments in the development of new alternatives. Government can play a role in ensuring that external costs are taken into account by markets, but ultimately markets are best suited to decide how to respond.
- Cars and light trucks are the largest users of petroleum. As a result, the fuel economy of the vehicles purchased and the number of miles that they are driven have a large effect on oil consumption.
- Congestion is a growing problem in American urban areas. Cities and States have shown a growing interest in and capacity for setting prices for road use during peak periods to reduce the full economic costs of congestion.

Chapter 7: Currency Markets

The need for international transactions provides the impetus for a huge, well-functioning market that facilitates currency conversions and allows global economic integration and trade to occur smoothly and quickly at low cost. Both by volume of trade and ease of making transactions, currency markets today are the world's deepest, most liquid markets. Currency markets range from common markets where parties simply exchange one currency for another to sophisticated markets where parties buy and sell currencies far into the future. The key points of Chapter 7 are:

- Foreign-exchange markets allow firms to trade goods and services across borders, and to manage the risks they face from fluctuations in the price of their domestic currency.
- As with any other good, the exchange value of a currency is determined by its supply, as well as the demand for the country's assets, goods, and services.
- Over much of the 20th century, countries tended to favor fixed exchange rates, but in recent decades there has been a shift toward freely floating exchange rates.
- Monetary and exchange-rate policies are tightly linked. A nation's government must decide between controlling its exchange rate and controlling its domestic inflation rate.

Chapter 8: International Trade and Investment

The United States derives substantial benefits from open trade and investment flows. Over many decades, increased trade and investment liberalization has been an important catalyst for greater productivity growth and rising average living standards in the United States. The key points of Chapter 8 are:

- Looking ahead, international trade liberalization in services presents significant opportunities for U.S. workers, firms, and consumers.
- Foreign direct investment (FDI) flows into the United States benefit the U.S. economy by stimulating growth, creating jobs, promoting research and development that spurs innovation, and financing the current account deficit.
- U.S. direct investment abroad is an important channel of global market access for U.S. firms. U.S. multinational companies have contributed to productivity growth, job creation, and rising average living standards in the United States.

Chapter 9: Immigration

The United States is a nation of immigrants and a nation of laws, and we value both historical legacies. Immigrants continue to make positive contributions to our Nation and our economy, yet our current immigration laws have proven difficult to enforce and are not fully serving the needs of the American economy. The key points of Chapter 9 are:

- International differences in economic opportunities and standards of living create strong incentives for labor migration. Once established, migration flows from a certain region tend to be self-perpetuating.
- Foreign-born workers make significant contributions to the American economy, but not all Americans gain economically from immigration. Foreign-born workers tend to be concentrated at the low end and the high end of the educational spectrum relative to native-born workers.
- Immigration policy plays a key role in determining the volume and composition of the foreign-born workforce. Comprehensive immigration reform can help ensure an orderly, lawful flow of foreign-born workers whose presence continues to benefit the American economy.